

Franchise Tax Board – Interested Parties Meeting
Topics of Discussion
March 30, 2007

The results of the prior interested parties meeting indicated that staff should begin to work towards the development of a regulatory solution to the gross receipts/treasury function issue as well as a statutory solution. With this in mind, staff has developed language for a proposed regulation in this area and similar language for a proposed statutory solution. The purpose of the March 30, 2007 meeting will be to discuss this language, and any other alternatives that are offered, in order to develop a proposal that can be taken to the Franchise Tax Board (FTB) for approval to either move forward into the formal regulatory process, or to support an item of legislation.

Comments made at the January meeting indicated that there was stronger support for a regulatory fix under the authority of section 25137 of the Revenue and Taxation Code (RTC) rather than to attempt to regulate under section 25120(e), which contains the definition of sales. FTB staff agrees that RTC section 25137 provides the authority for such a regulation and therefore staff has developed regulations under RTC section 25137.

Regulatory Proposals

The first regulation that staff proposes for discussion is derived from the model regulation adopted by the Multistate Tax Commission. This regulation has already been adopted in other states and provides a reasonable basis for the California regulation as well. Staff also includes a second alternative regulation, which is shorter and specifically excludes hedging activities from the definition of "treasury function". While staff believes that hedging causes the same distortion problems as treasury function investments of working capital, the inclusion of hedging is felt by some to be outside the scope of this particular project. This version also excludes the receipts in issue completely, rather than reducing the receipts to net income.

Staff regulatory proposal 1 raises the following issues for discussion:

Subsection (c)(1)(D) of the regulation sets forth the rule that if the taxpayer has a treasury function, then the receipts derived from liquid assets held by that function are included in the sales factor only to the extent of "overall net gain".

Subsection (c)(1)(D)1. defines the term "liquid assets" and sets forth that stock in unitary subsidiaries, and entities such as suppliers or distributors, are not liquid assets.

1. Is the scope of "liquid assets" reasonable?
2. Would the regulation be easier to apply if it simply stated that liquid assets are "all marketable intangibles", rather than listing specific types of investments?
3. Is there a need to address business/nonbusiness issues in this context, such as pools of funds that are far in excess of what is needed to provide for the day-to-day needs of the business?

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Subsection (c)(1)(D)2. defines the term "treasury function" as a function that pools together and manages the liquid assets. This definition also includes as a treasury function the activity of managing assets that are reserved for business contingencies and business acquisitions. This subsection also excludes from the definition of "treasury function" those taxpayers whose businesses are principally engaged in the purchasing and selling of liquid assets.

1. Is this definition adequate or should it be broadened to also address other asset management functions such as hedging of raw materials or foreign receivables? Hedging clearly affects the cash flow of the business and can have a similarly distortive effect on the sales factor.
2. Is the exclusion for dealers in intangibles adequate? Should it be modified to define what "principally engaged" means?
3. Are there business/nonbusiness issues that are impacted by this definition?

Subsection (c)(1)(D)3. provides how net income from the treasury function is calculated. This subsection seems straightforward and simply provides that net income means net income for the tax period.

Staff regulatory proposal 2 raises the following issues for discussion:

1. Is this shorter form preferable?
2. Does the elimination of these receipts rather than a reduction to net income seem like a better approach?
3. Is this version's use of the term "intangible assets" preferable to the defined term "liquid assets" included in proposal 1?

Statutory Alternatives

The statutory changes that staff wishes to discuss are based on the regulatory language set forth in proposals 1 and 2. Because these changes could be placed either under RTC section 25120(e) or under RTC section 25137, statutory proposal 1 is set forth as an amendment to RTC section 25120(e) while statutory proposal 2 is set forth as an amendment to RTC section 25137. Similar issues to those raised by the regulations clearly apply to these proposals as well. But in addition, staff would like to solicit input regarding which RTC section, 25120(e) or 25137, is the better choice for the proposed amendments.

Participants at the meeting will be asked to discuss these issues as well as providing their own input regarding the proper regulatory or statutory response to this issue. Staff will then report on this meeting, as well as the first interested parties meeting, to the FTB at its April 4th meeting.

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Regulatory Proposal 1

Add new subsection (D) to Regulation section 25137(c)(1) to read as follows:

25137(c)(1)(D) If a taxpayer holds liquid assets in connection with the treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain from those transactions for the tax period is included in the sales factor.

1. For purposes of this subsection, a liquid asset is an asset (other than functional currency or funds held in bank accounts) held to provide a relatively immediate source of funds to satisfy the liquidity needs of the trade or business. Liquid assets include foreign currency (and trading positions therein) other than functional currency used in the regular course of the taxpayer's trade or business; marketable instruments (including stocks, bonds, debentures, options, warrants, futures contracts, etc.); and mutual funds that hold such liquid assets. An instrument is considered marketable if it is traded in an established stock or securities market and is regularly quoted by brokers or dealers in making a market. Stock in a corporation which is unitary with the taxpayer, or which has a substantial business relationship with the taxpayer is not considered marketable stock.

2. For purposes of this subsection, a treasury function is the pooling and management of liquid assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. A taxpayer principally engaged in the trade or business of purchasing and selling instruments or other items included in the definition of liquid assets set forth herein is not performing a treasury function with respect to income so produced.

3. Overall net gain refers to the total net gain from all transactions performed by the treasury function for the entire tax period, not the net gain from a specific transaction.

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Regulatory Proposal 2

Add new subsection (D) to Regulation section 25137(c)(1) as follows:

25137(c)(1)(D) The numerator and denominator of the sales factor shall exclude interest and dividends from intangible assets held in connection with a treasury function of the taxpayer's unitary business as well as the gross receipts from the maturity, redemption, sale, exchange or other disposition of such intangible assets.

"Treasury function" is the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. Treasury function does not include a taxpayer's trading function that purchases and sells future contracts, products, or commodities related to the business of the taxpayer, or related to hedging price risk of the products or commodities consumed, produced, or sold by the taxpayer. A taxpayer principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function is not performing a treasury function with respect to income so produced.

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Statutory Proposal 1

Amend RTC section 25120 as follows:

As used in Sections 25120 to 25139, inclusive, which shall hereafter be referred to as "this Act," unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Nonbusiness income" means all income other than business income.

(e)(1) "Sales" means all gross receipts of the taxpayer not allocated under Sections 25123 through 25127 of this code.

(2)(A) Notwithstanding Section 38006, gross receipts arising from a treasury function shall be limited to the overall net gain, including interest and dividends, realized from transactions undertaken as part of a treasury function.

(B) For purposes of this paragraph, all of the following apply:

(i) "Treasury function" means the pooling, management, and investment of liquid assets for the purpose of satisfying the cash flow needs of the trade or business, including, but not limited to, providing a reserve for business contingencies and business acquisitions.

(ii) "Liquid asset" means a readily marketable intangible, including, but not limited to, stocks, bonds, debentures, options, warrants, future contracts, foreign currency, and mutual funds that hold those intangibles. "Liquid asset" does not mean currency held in bank accounts if that is the currency that the business regularly used in the conduct of its trade or business, unless that currency is an instrument that may be purchased or sold for a gain or loss. An intangible is considered marketable if it is traded in an established stock or securities exchange or market and is regularly quoted by brokers or dealers.

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(iii) An equity interest in a business entity, such as stock in a corporation, that is unitary with the taxpayer, or that has a substantial business relationship with the taxpayer, is not considered a marketable intangible.

(C) A taxpayer principally engaged in the trade or business of purchasing and selling instruments or other items included in the definition of liquid assets set forth herein is not performing a treasury function with respect to income so produced.

(f) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

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Statutory Proposal 2

Amend Rev. and Tax. Code section 25137 as follows:

(a) If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the FTB may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

~~(a)~~(1) Separate accounting;

~~(b)~~(2) The exclusion of any one or more of the factors;

~~(c)~~(3) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

~~(d)~~(4) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(b) The numerator and denominator of the sales factor shall be modified to exclude interest and dividends from intangible assets held in connection with a treasury function of the taxpayer's unitary business as well as the gross receipts from the maturity, redemption, sale, exchange or other disposition of such intangible assets.

(1) "Treasury function" is the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. Treasury function does not include a taxpayer's trading function that purchases and sells future contracts, products, or commodities related to the business of the taxpayer, or related to hedging price risk of the products or commodities consumed, produced, or sold by the taxpayer. A taxpayer principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function is not performing a treasury function with respect to income so produced.

(2) Nothing in this subdivision shall preclude a taxpayer from petitioning the Board pursuant to subdivision (a) if the exclusion of gross receipts from intangible assets held in connection with a treasury function of the taxpayer's unitary business does not fairly represent the extent of the taxpayer's business activity in this state.